



THE BOSTON CONSULTING GROUP

White Paper

Capital Markets Businesses at Europe's Universal Banks: Exit or Transform?

Patrick Uhlmann, Pascal Vogt, and Volker Vonhoff

December 2017

The capital markets business in Europe is changing. Revenue pools have shrunk and are likely to move sideways going forward, while technology-driven players (fintechs, buy-side firms, data providers, exchanges, and principal trading firms) are starting to take market share. As Brexit plays out, competition is set to intensify with banks (in the most likely scenario) relocating units from London to mainland Europe and closer to regional clients. Our base case is a 50 percent rise in competition in attractive client segments such as corporates/SME and institutional clients/asset managers.

Rising competition isn't the only reason to think again about the traditionally-compelling capital markets business. Regulation—especially that requiring a separation of commercial and investment banking, Basel IV, the Fundamental Review of the Trading Book, and MiFID II/MIFIR—will continue to lift capital requirements and balance sheet costs, putting pressure on the bottom line. Customer protection, meanwhile, has come to the fore, and the cost of regulatory compliance is rising. Depending on a bank's client base and product portfolio, these factors could mean a 20 percent to 50 percent decline in capital markets earnings over the coming years.

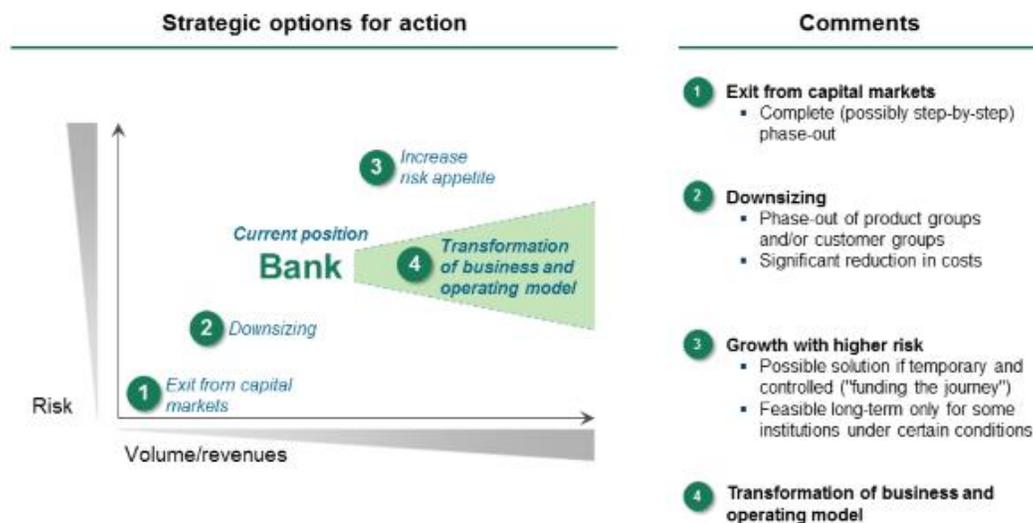
Many bank clients are themselves going through transitions—examples include Industry 4.0 for corporates and the ongoing zero-interest rate environment and digitalization affecting insurers and pension funds. The transformational efforts being made by these groups will be reflected in their demands on the capital market businesses of the future.

Business models and processes are also changing. Smart digital technologies such as artificial intelligence and robotics, along with the expansion of utility businesses (i.e., e-trading), are impacting the entire value chain, enabling scaling effects. Technology-driven players have widening access to revenue pools, and

technological innovation will boost capital markets insourcing and outsourcing. An additional challenge for incumbents is to develop new technologies in the context of entrenched legacy IT platforms. That is particularly tough because cost efficiency supported by a strong architecture has rarely been a focus in the past, perhaps because strong revenue performance made them less important.

Rising costs and technology changes in capital markets would seem to suggest that the sustainable capital markets businesses of the future must be of a minimum size. This leads to a vital question for European universal banks, and particularly medium-size institutions: will only the largest providers survive, or are there other possibilities and strategic opportunities beyond exit or gradual phase-out? (See Exhibit 1).

Exhibit 1: Strategic options for European universal banks with capital markets businesses



THE BOSTON CONSULTING GROUP

Capital Markets Businesses: Exit or Transform

To continue to navigate this still-attractive but increasingly-contested segment, leaders are required to reevaluate all elements of their capital markets business models and related operating models.

Creating transparency on the status quo and required actions. The past performance of capital markets businesses cannot serve as the basis of predictions about the future. Instead, banks should undertake a thorough scenario analysis to gauge the impact of the changing environment on revenues, costs, and resources—initially without mitigation measures. A bank’s specific resources for the business are decisive inputs: examples include deployable capital/RWA, balance sheet volumes, and available investment and cost budgets. Banks must also carry out a SWOT (strengths, weaknesses, opportunities, threats) analysis, taking into account their financial resources, rating/reputation, existing client relationships, product competencies, specialist capabilities, and IT platform capabilities.

An integrated simulation model can help business leaders analyze scenarios, their impacts on performance, and required resources. The approach can also enable the identification of gaps in the current offering and aid the evaluation of specific client or product groups, including the risk of failing to achieve critical mass. This may lead to a recommendation to phase out certain client or product groups, or to exit the capital markets business entirely, possibly over time.

If the business is maintained, a comprehensive overhaul is likely to be necessary.

Refining steering to lay the foundation. Elements that may previously have been neglected must be integrated into steering the capital markets business. Risk/capital, liquidity, human resources/know-how, operating costs, and investments should all be taken into account based on an integrated approach so

that correlating factors are recognized and the overall impact is optimized. Some options will be less accessible than in the past. For example, it will be considerably more difficult to finance IT investment through revenue increases generated by taking higher risks (e.g., larger trading books).

Revising the client coverage model to improve effectiveness. One goal of new regulatory requirements is to ensure that clients have access to the capital markets products they need for risk management and investment, and to shield them from uncontrolled risks. New rules separating commercial and investment banking and MiFID II must be implemented with that principle in mind across the organization, interfaces, and activities of capital markets units. Customer centricity is a new paradigm, and represents a move away from the product-driven models of the past.

Capital markets units of European universal banks must therefore change to differentiate themselves meaningfully from tier one global banks and investment banks, adopting coverage models that benefit from proximity to regional clients and familiarity with regional industries. To take advantage they must:

- precisely define homogenous client groups and relationships
- segment clients in each group (on the basis of both industry and potential) for a differentiated and suitable coverage model—including consistent tail management
- analyze the (existing and anticipated) business needs of clients in each segment and cross-check against the bank's competencies
- develop specific solutions/products for client groups that have business potential, and that can be produced profitably by the bank
- make holistic advisory and client coverage a priority, and relieve the sales force as much as possible from non-client-facing tasks.

The central challenge—and opportunity—for capital markets units at universal banks is to retain relevance to clients. This is possible only when a bank has a detailed understanding of its clients and offers correspondingly tailored solutions.

A viable capital markets unit is predicated on focusing the coverage model and resource allocation on value creation for clients and overall client profitability, rather than on separately measuring the sales success of individual products, as in the past.

Developing tailored products to serve client needs and retain relevance.

Banks must make further adjustments to move away from a product-driven approach—in which the trading book is the primary driver of trading activity—and toward a client-centric model. To do so they are required to systematically analyze and anticipate their clients’ capital market and risk management needs, taking into account the changes clients themselves are facing (arising from markets, competition, regulation, and technology). Client needs must then be aligned with the bank’s product competencies and IT capabilities. An “originate to distribute” approach should be considered by some banks (combining capital markets investments and financing), with the bank playing the role of a broker/risk platform in a resource-efficient manner.

Banks should develop and bundle solution packages that address the requirements of selected client groups. In the best case, a bank may have market-leading niche products that can be more actively positioned. In any event, the entire product offering should be put through a cost analysis (both operational and regulatory costs). Banks may “white label” some products, but may also pull out of others completely.

One result of these efforts will be a need for a more rigorous product development process, based on strong coordination and continuous reprioritization of the pipeline to align with client needs and profitability.

Adopting active cost management and targeted technology investment to ensure efficiency and profitability. Capital markets units were for a long time able to rely on strong revenues to cover almost any costs they incurred. However, regulation and technology are overturning this paradigm. Now, stringent and

proactive cost management are important, particularly for universal banks, to sustain a sufficiently profitable business model. All segment costs “front to back” must be considered and actively managed—from sales and trading through back office, finance/risk, and IT.

One key cost lever is to bundle non-client tasks as shared services in a central support unit. This frees up time in the sales force and facilitates standards and scale effects in areas such as product process coordination, project portfolio management, IT services, regulatory strategy, and HR-related tasks.

A large share of setup costs and required investments—which are expected to rise even higher in future—will be in IT and new technology. Since changes to IT platforms take time, it is key to develop a medium-term target picture for IT, including digital components, and to quantify run and change costs. This target picture should include offerings on e-trading platforms as well as the technical interfaces and APIs offered to clients to directly connect with the bank’s infrastructure.

The strategic make-or-break question is whether a client-oriented business model can sustainably earn enough to cover cost components (including investments). If not, downsizing capital markets activities or exiting them completely is an option that should not be ruled out.

Ambitious Steps Toward a New Reality

When a bank opts to transform its capital markets business after weighing the strategic questions comprehensively and objectively, significant changes are likely to be necessary across nearly all dimensions of its business and operating model. However, the transformation must usually be accomplished with limited resources and investment budget—due to numerous competing projects—and within just a few years. This is possible only with a targeted and ambitious approach that is carefully thought out and continuously and actively monitored.

Regulatory, market, competitive, and technology changes present a daunting challenge for the capital markets units of European universal banks, which must make investments against significantly smaller business volumes than global leaders.

At the same time, however, some of these universal banks will discover opportunities to differentiate themselves from larger players. They can achieve this goal through a clear client orientation that makes use of regional proximity and existing deep relationships, a holistic coverage model, a combination of advisory and tailored solutions, and an optimized and stringently controlled operating and steering model.

Patrick Uhlmann
Pascal Vogt
Volker Vonhoff

About the Authors

Patrick Uhlmann is a Partner & Managing Director in the Stuttgart office of The Boston Consulting Group. He specializes on CFO/Finance, bank steering, and capital markets. He can be reached at uhlmann.patrick@bcg.com.

Pascal Vogt is an Associate Director in the Cologne office of The Boston Consulting Group. He is an expert on risk management and is BCG's global topic leader for treasury. He can be reached at vogt.pascal@bcg.com.

Volker Vonhoff is a Principal in the New York office of The Boston Consulting Group, specializing in capital markets and risk management topics. He can be reached at vonhoff.volker@bcg.com.

About BCG

The Boston Consulting Group (BCG) is a global management consulting firm and the world's leading advisor on business strategy. We partner with clients from the private, public, and not-for-profit sectors in all regions to identify their highest-value opportunities, address their most critical challenges, and transform their enterprises. Our customized approach combines deep insight into the dynamics of companies and markets with close collaboration at all levels of the client organization. This ensures that our clients achieve sustainable competitive advantage, build more capable organizations, and secure lasting results. Founded in 1963, BCG is a private company with offices in more than 90 cities in 50 countries. For more information, please visit bcg.com.

* * *